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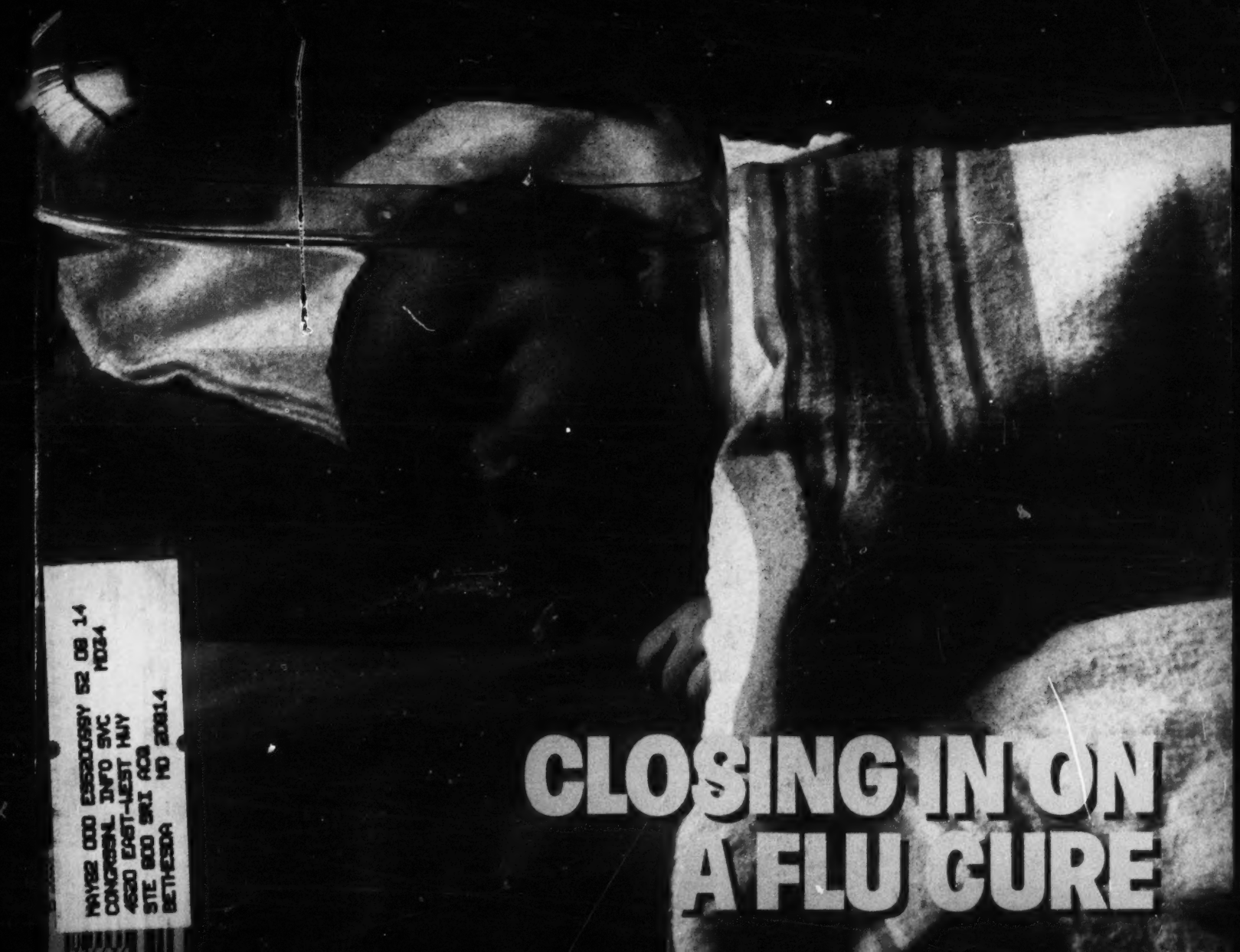

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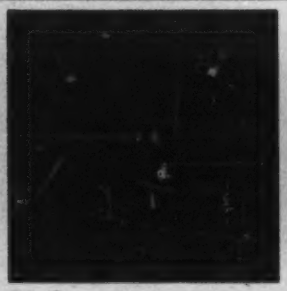

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POLICY

Housing's Unsheltered Future

The Reagan Administration wants the federal government to stop hovering over the industry.

by ROBERT LUBAR

No sector of the U.S. economy, with the possible exception of auto manufacturing, has taken such a savage beating in the last couple of years as that vast agglomeration of construction firms, mortgage bankers, mortgage insurers, and savings institutions that make up the housing industry. Its own special recession, which knocked output and sales to subterranean levels not seen for decades, appears to have bottomed out. But its recovery promises to have much less bounce than in the past, when housing rebounds customarily recharged the whole economy. This time, the ravages of double-digit inflation and wildly oscillating interest rates have compounded the damage dealt by the general cyclical downturn, leaving the industry in need of major structural repairs.

Just as the automakers had to revamp their product lines and marketing in response to OPEC's thunderbolts, so the housing industry will have to develop new sources of capital, and new ways of attracting it, in this transformed economic and financial environment. Old standbys like the 30-year fixed-rate mortgage have gone the way of Detroit's gas-guzzling dinosaurs. The homebuilders don't have to fend off imports, of course, but they've got a problem just as disturbing: how to keep their product from pricing itself out of the market.

One of the most remarkable things about the industry's predicament is the government's reaction to it. Far from rushing in with liberal doses of emergency aid, the Reagan Administration has been signaling a deliberate federal disengagement from the housing business. It has written off programs that subsidize construction as costly failures and is seeking to replace them with more efficient and effective ways to

house the poor. And it is convinced that some other government programs cherished by builders actually inhibit the industry from adapting to new conditions. "We should ask," says one White House staff man, "not what we can do to help, but what we can undo."

A full articulation of the Administration's intentions awaits the final report, due in April, of the President's Commission on Housing, which Reagan set up last June to help formulate a policy consistent with his economic program. Its 30 members include former government officials, bankers, builders, and others familiar with the industry. The chairman, William McKenna, is a Los Angeles lawyer who helped reorganize federal housing programs in the Eisenhower Administration, and the vice chairman is Carla Hills, who headed the Department of Housing and Urban Development in the Ford Administration. The commission's interim reports have indicated that it is taking a detached, pragmatic view of its assignment.

Analyzing the binge

The Administration's attitude, however, is also influenced by the feeling that housing has been too much cosseted in the past, to the detriment of the rest of the economy, and should now be left to fend for itself. Some conservative economists whose advice is heeded at the White House surmise that tax advantages and other preferential treatment have given housing favored access to credit and capital, and lured investment away from industrial plant and equipment.

Whether such diversion actually took place is hard to prove, but an enormous amount of money obviously went into housing. Martin Feldstein, the president of the National Bureau of Economic Research, cites some indicative figures: "The ratio of net investment in residential capital to net investment in plant and equipment rose from 52% in the last half of the 1960s to 76% in the last half of the 1970s."

Certainly, in the 1970s residential real estate was a much better inflation hedge than the stocks and bonds of industrial corporations. As the prices of houses shot to unbelievable heights, homeowners "saved" by watching their equity grow, building up virtually tax-free capital gains, or cashed in their profits by remortgaging their property and using the proceeds to pay for big-ticket consumer items. The conclusion is hard to avoid that this binge deprived the economy of some genuine savings and productive investment it badly needed.

One manifestation of this line of thinking is the serious consideration the Treasury and the Office of Management and Budget gave to abolishing or at least limiting the tax deductibility of mortgage-interest payments, long regarded as one of the most impregnable provisions in the internal revenue code. The slump in housing probably rules out such action now, but the fact that it has become a mentionable topic demonstrates that it is a lot safer to defy the housing lobby than it used to be.

In fact, the industry has been remarkably restrained in its reaction to the change in the political climate. Its leaders seem unwilling to believe that their long-lived special relationship with government is in peril. Housing has been more intimately intertwined with government than any other industry except defense. The nation's commitment to provide adequate shelter was formalized in a 1949 act of Congress that set as a national goal "a decent home in a suitable living environment for every American family." In pursuit of that goal, the federal government poured forth billions of dollars, with results that were good, bad, and indifferent. But its most significant contribution was the array of institutional innovations, some dating back to the 1930s, that became the framework of the modern housing industry. These included long-term, amortized mortgages and much of the organizational machinery to originate them, insure or guarantee their repayment, and provide a secondary market for them. Indeed, it can be said that the government invented the industry.

The long public-private collaboration has to be judged fruitful, on the whole. Americans are surely the best-housed people on earth; two-thirds of all U.S. households enjoy the benefits and satisfactions of owning their own homes. Now the Administration seems ready to close that chapter and to put the industry on its own.

The affordability gap

Its prospects are tantalizing. On the one hand, the inevitable arithmetic of demography is promising a dazzling potential market for new housing. Some 41 million Americans, ten million more than in the 1970s, will be turning 30 during this decade. By past reckonings, they should be forming new households at a rate that would call for construction of more than two million homes every year—enough to assure the industry of a prosperity more bountiful than any it has ever known. But that enticing prospect will be translated into real demand only if those battalions of young homemakers can find housing at a price they can afford.

An "affordability gap" is what is depressing the industry now. If it persists, the Administration will be pressured to fill the gap with hastily improvised subsidy schemes; the National Association of Home Builders came up with a few at its annual convention in Las Vegas a few weeks ago. But the Reaganites seem determined to resist entreaties to shore up the builders. They believe subsidies should be confined to the very poor. And even in this area, the Administration is phasing out some of the more generous programs it inherited and is contemplating replacing them with a wholly new approach.

Four decades of federal housing efforts have cleared away some of the slums and improved inner-city landscapes, but they've done little to relieve the affordability crunch for the poor. According to the

Research associate: Brian Dumaine

Illustrations by Randall Enos

President's commission, well over half the households at the bottom of the income scale pay out more than 30% of their earnings for rent, and almost a quarter of those households pay more than 50%.

Such is the sorry outcome of a policy that emphasized construction subsidies—subsidies paid to the builder to cover part of the land and construction costs or the interest on money he has to borrow. There are several troubles with this kind of subsidy. It is inherently costly because it weakens the builder's incentive to control expenses and because it emphasizes new construction when existing buildings could be made to serve just as well. Its costliness in turn limits the number of projects that can be built, with the result that a few of the needy live better than the rest. And finally, it leaves the government with contracts to pay the subsidy over the life of the building (typically 20 to 40 years). The total amount of future obligations has, in the words of HUD Secretary Samuel R. Pierce Jr., "soared to the point where more than a quarter of a trillion of taxpayers' funds has been committed."

The horror story of the notorious Section 8 program is a worst-case example (see chart, opposite page). On average, each apartment unit built under the auspices of this federal folly costs $150,000 over the life of the contract. HUD has cut back drastically on new commitments, but the budgetary overhang will persist long after the last commitment has been made.

Let the tenant choose

There is a better way. That's to pay the subsidy direct to the tenant. The President's commission has come out enthusiastically for this consumer-oriented, rather than construction-oriented, approach. Poor people would choose where they want to live and would pay the going rent; the government would pay the difference between that and a stipulated percentage (probably 25%) of the tenant's income. (Presumably there would be a limit on the allowable rent; no one is proposing to house the poor in Park Avenue penthouses.) Such Consumer Housing Assistance Grants (CHAG) would go to the heart of the affordability problem: all of the subsidy goes straight to the intended beneficiaries, who are free to select their own housing. And the dollars go a lot further. Using evidence gleaned from an encouraging ten-year experimental program conducted in 12 cities by HUD, the commission maintains: "Twice as many households can be served at any given level of funding under the consumer-oriented programs as under the construction programs."

Longtime followers of the Milton Friedman school of conservatism will no doubt recognize the strong resemblance between CHAG and the voucher system the professor advocates for education. The idea has strong appeal for Reaganites and could turn out to be their first really interesting initiative in social legislation.

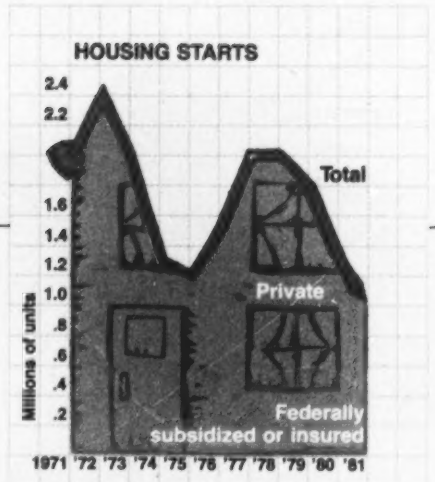
Several tough questions remain to be answered, though. First, who will be eligible? The Administration is anxious not to create another open-ended entitlement by drawing the line at some specified income level. Second, how do you deal with the all-too-likely problem of discrimination? A virtue of CHAG is that it would encourage the dispersal of the poor in middle-class neighborhoods rather than segregating them in grim new ghettos as construction subsidies do. But that assumes they'll be welcome. If they are not, if some poor black family meets resistance, anti-discrimination laws will have to be vigorously enforced.

Finally, what is to assure that enough apartments will be available to accommodate any really significant CHAG program? In many parts of the country, vacancy rates are already very low as a result of a lag in rental construction caused by the failure of rents to keep pace with inflation. Advocates of CHAG concede that it probably won't do much for new construction, but argue that it will spur landlords into renovating run-down properties instead of abandoning them. And saving buildings from abandonment is a much quicker and cheaper way of adding to the nation's housing stock.

When it comes to the mainstream of the housing market, the Administration's evolving policy holds forth no quick comfort for either homebuilders or those aspiring to be homeowners. While the Administration is eager to get rid of the legal obstacles that inhibit the flow of capital to the industry, it is just as committed to dismantling the mechanisms that have given housing preferential treatment in the marketplace for money.

Why the money stopped

According to a perceptive analysis by Anthony Downs of the Brookings Institution, "The true cost of mortgage borrowing declined sharply from about the mid-1960s to about 1978." This happened because borrowers were subsidized by lenders, who remained willing to make long-term mortgage commitments at relatively low fixed rates, even though inflation was depreciating the value of the repayments. The savings banks and savings and loan associations that did the bulk of



The Builders' Helper

That bent nail tracks the dramatic annual variations in housing starts. From an all-time high of 2.4 million units in 1972, starts slumped during the mid-decade recession, then rebounded to about two million in 1978 and 1979. After that they headed for the cellar, and last year totaled a paltry one million units. The slump is the longest since the end of World War II. Federal aid in the form of subsidies or mortgage insurance went into about 30% of all homes started during the Seventies, but in 1980-81 the figure averaged 40%. The Reagan Administration would like to bring it down drastically.

As for new sources of mortgage capital, the pension funds are everybody's candidate.

the lending were in turn subsidized by their depositors, who accepted a return on their savings well below the inflation rate.

Then the money stopped. As inflation worsened, the depositors stopped playing fall guy and put their savings into money-market funds. To replace this money the thrifts borrowed at rates exceeding the return on their outstanding loans. Rates on new mortgages naturally shot way up, and lenders began to embrace variable-rate mortgages as inflation protection. But many thrifts have been left with their reserves exhausted and losses on their current operations. Thus ended the system that financed housing for 40 years.

The system that takes its place will not be built on the shaky foundation of small savings deposits; ampler, more stable sources of mortgage funds will have to be tapped. As for the shattered thrift institutions, the prescription for their return to viability calls simply for more freedom—freedom to take on corporate accounts, for example, and to diversify their asset portfolios by going into consumer and commercial loans, investing in real-estate equity, and buying municipal bonds. This approach was endorsed by the President's commission in a preliminary report in January. It is a good illustration of how government can help by "undoing," for it is federal legal restrictions that have kept the thrifts in their present furrow.

Some of the builders are far from delighted with the idea. They fear that, once liberated, the thrifts would leave the mortgage business in the lurch. The savings bankers themselves are reassuring on that score; they have no intention of abandoning, en masse, what they know best. And, as the commission noted, "A strong industry that devotes a smaller portion of its portfolio of assets to mortgages could be a better source of housing funds than a weak industry fully committed to mortgage investment."

Legislation liberating the thrifts is high on the agenda of the Senate Banking Committee, whose chairman, Republican Jake Garn of Utah, has become a passionate advocate of bank deregulation across the board. He's been having a hard time, however, convincing commercial bankers that they have nothing to fear from letting the thrifts loose in their lending pastures. Says Garn: "I've been on a campaign telling these people that the real competition is going to come from the new financial-service giants, and if you don't think that's real competition, wait until Sears is offering money-market funds in all of its mail-order outlets." Specialization is swiftly becoming obsolete in the evolving market for financial services, and the lawmakers will have to catch up.

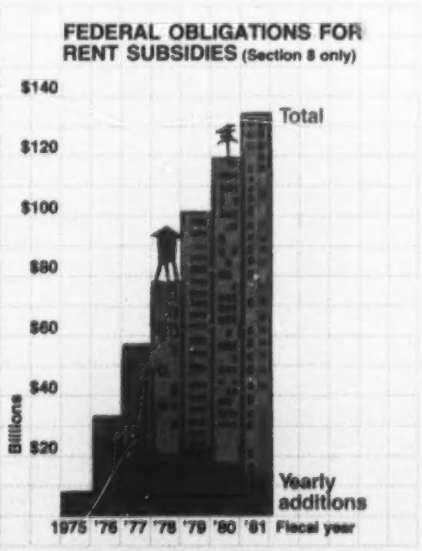
As for new sources of mortgage capital, the pension funds are everybody's candidate. With some $600 billion in assets, they represent a vast and steadily growing reservoir of investable funds. Since their liabilities (obligations to pay retired employees) are characteristically very long term, they are less concerned than bankers with gyrations in interest rates. Yet only a minute fraction of pension money has been invested in home mortgages.

The principal obstacle has been the Employee Retirement Income Security Act of 1974 (ERISA). Its rigid conflict-of-interest rule has barred the construction industry's retirement funds, for example, from investing any of their $20 billion of assets in housing. In addition, some mortgages do not meet the act's definition of investments a "prudent man" would make. Amendments to ERISA have been introduced in Congress, and the Labor Department is moving to liberalize the rules governing investment in residential mortgages.

Double protection

As they move more and more into housing, the pension funds and other big institutional investors wouldn't be bothered with the details of dealing with home buyers, checking their creditworthiness, and servicing individual loans. That would be handled by S&Ls, commercial banks, mortgage bankers, securities firms, and maybe even retailers. Lendable funds would be generated by bundling mortgages into packages and selling them to pension funds and other investors in the form of pass-through securities that can be publicly marketed like bonds. These securities would resemble mutual funds in that the composite yield on a portfolio of mortgages is passed through to the investor.

Pass-through securities are already a reality, of course. They've been a hit with investors ever since they were first introduced by the Government National Mortgage Association in 1970. "Ginnie Maes"



Mortgaging the Future

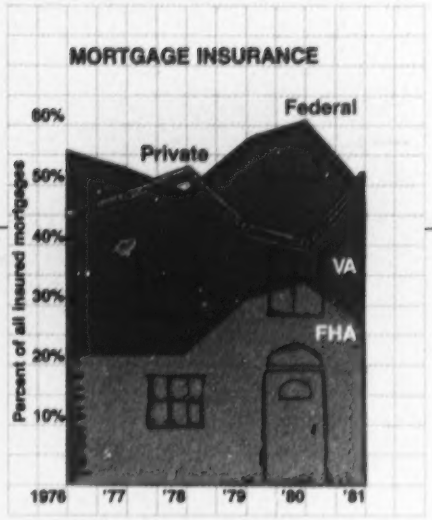
Since 1975, when HUD instituted the Section 8 program to spur construction of low-income rental housing, the government has committed itself to pay out a dizzying $136 billion in subsidies over the next 30 to 40 years. The program guarantees landlords a "fair market value" rent and makes up the difference between that and a stipulated portion (on average, 30%) of the tenant's income. In cities where rents are high, Uncle Sam will end up paying $250,000 per unit (in 1981 dollars). Other federal programs for housing bring the taxpayers' total obligations for subsidies to a whopping quarter of a trillion dollars. HUD now wants to end the Section 8 construction subsidies.

have a special appeal because they are doubly guaranteed by the U.S. government. The mortgages that they represent are insured by the Federal Housing Administration or guaranteed by the Veterans Administration, and the securities themselves are backed by the full faith and credit of the government. All together, investors hold more than $120 billion of Ginnie Mae securities.

Alas, Ginnie Mae's very success caused the agency to run afoul of David Stockman's OMB, which this winter lowered the ceiling on the agency's annual commitments. There have even been rumors that OMB intends to phase the agency out entirely. That's been denied, but OMB has passed the ominous word that "the future of Ginnie Mae beyond 1983 has not been decided." FHA's fate also hangs in limbo.

This isn't a simple budget matter: Ginnie Mae actually makes a little money for the Treasury. The problem is that ironclad government guarantee. As part of what it calls a "credit-budget exercise," OMB has its ax out for off-budget federal loan guarantee programs of all kinds. Last year these programs took on a net total of $30 billion in guarantees—covering over 7% of all the money borrowed in this country—and Ginnie Mae accounted for a hefty slice of that. What troubles OMB is that the system gives housing a special advantage over other industries lining up in the credit market: securities with a federal guarantee can be sold even in the shakiest markets. OMB would have no objection to Ginnie Mae if it were "privatized"—that is, if the government guarantee were stripped off its securities.

When word of OMB's intentions got around at the end of last year, the housing industry was finally moved to protest. The National Association of Home Builders, the Mortgage Bankers Association, and the National Association of Realtors denounced plans to "dismantle" Ginnie Mae and FHA as "reckless, deceptive, and unjustifiable." The three trade groups make up one of Washington's most formidable lobbies, and they could blow up a fearful brouhaha in Congress.



Catching Up

From 1934 until the late 1950s, when the first modern mortgage-insurance company started up, the U.S. government was the only insurer of home mortgages. Now the private insurers have caught up. The insurance is sold primarily on higher-risk mortgages (for example, those on houses bought with down payments smaller than 20%). It enables lenders such as S&Ls to sell the mortgages in the secondary market. The Administration would like to see private insurers take over the bulk of the business now handled by the Federal Housing Administration. VA insurance wouldn't be touched.

A privatized Ginnie Mae would have to compete on more equal terms in the growing market for conventional pass-throughs. Such securities have been marketed by commercial banks, S&Ls, and mortgage bankers since 1977. Their combined offerings have doubled during each of the past few years, and the cumulative total reached nearly $9 billion at the end of the third quarter of 1981. Recently the Federal National Mortgage Association (Fannie Mae) began marketing pass-throughs patterned after Ginnie Mae's but without the federal guarantees. Fannie is stockholder owned and almost, but not quite, independent of government.

Milwaukee MGIC

The chief instigators of all this activity have been the dozen or so private mortgage-insurance companies that stand behind the private pass-throughs. They have done a lot of growing since Max Karl founded MGIC, the first modern mortgage insurer, in Milwaukee 25 years ago (see the article on page 52 about Baldwin-United, which is planning to buy MGIC). The industry could handle most of the business it would get if government competition were removed from the scene. As it is, the private insurers have made deep inroads into FHA's share of market, and not by skimming the cream off the top. They have been underwriting more mortgages than FHA at the higher-risk end of the scale. A report by Arthur D. Little Inc. in 1975 confirmed the insurers' contention that they could withstand almost any shock, even approaching the kind of default scenario that would come with another depression. A more recent Little report takes a more qualified view on the grounds that new developments in mortgage instruments introduce a higher degree of uncertainty.

The builders have great respect for the private insurers. Nevertheless, defenders of FHA and Ginnie Mae can work up quite a passion in recalling how low-down-payment, government-backed mortgages brought homeowning within reach of the mass of Americans. The guarantee, they maintain, is just as vital today. It is the most dependable generator of mortgage funds available, and it is making some mortgages a little cheaper; interest rates on Ginnie Mae securities are about half a percentage point lower than those on non-guaranteed pass-throughs.

Since high monthly carrying charges are the No. 1 villain of the current housing mess, no one in Washington would argue for a policy that would make mortgages costlier or harder to get. Rather the Administration is making a point that transcends housing. The point is that most industries, including housing, can thrive unaided in a healthy economy. As an OMB spokesman put it, "All the Ginnie Maes, Fannie Maes, FHAs, and VAs put together have not prevented the worst housing slump in history. It's interest rates that are doing the damage." Bringing rates down, which implies getting control of inflation, could be the only special favor housing needs. ■

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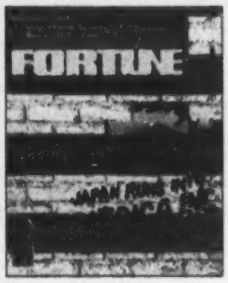

The cover's protectionist wall was built of synthetic brick by Nicholas Fasciano and photographed by Dan Kozan. The view of Mount Fuji is a shot by Mike Yamashita/ Woodfin Camp. How a Japanese company ran into the wall is described in the article beginning on page 56.

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March 22, 1982

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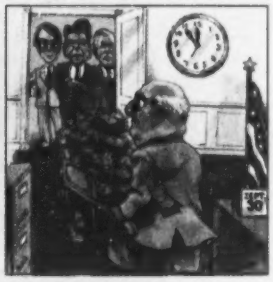

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INNOVATORS

A Champ of Cheap Airlines

Rock-bottom fares and savvy marketing are fueling a steep lift-off at People Express.

by PETER NULTY

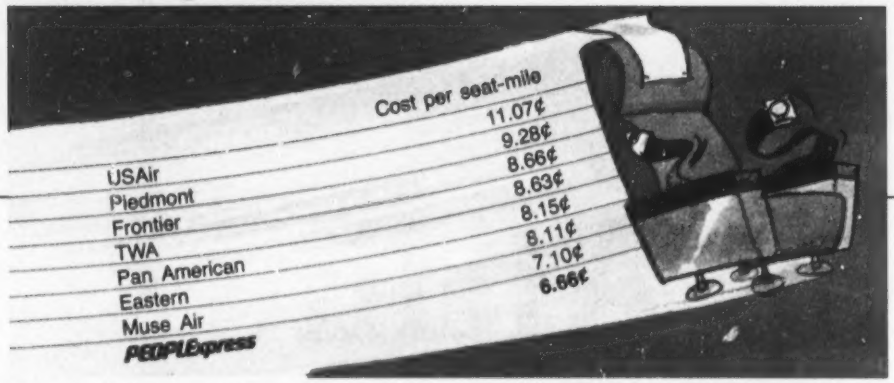
In the last three years airline executives have flown into deregulation, two recessions, the air-traffic controllers' strike, and exhausting price wars. Last year, the worst in airline memory, the U.S. industry had operating losses of around $300 million. There are fears that some airline companies—Braniff and Republic are frequently mentioned—could go out of business. The turbulence aloft isn't confined to American carriers. Sir Freddie Laker's Skytrain went down on the North Atlantic last month. But in a dingy suite of offices in Newark Airport's old North Terminal, People Express Chairman Donald C. Burr, 40, smiles as though a party is beginning.

One of a half-dozen jet-flying airlines born of deregulation, People Express has executed the fastest takeoff of any. The company started last April with three Boeing 737s traveling from Newark to Buffalo, Columbus, and Norfolk. By year's end it had 13 of the planes flying to ten cities and was surpassing the older fledglings, Midway and New York Air, in the number of miles it carried paying passen-

Chairman Donald Burr, shown in the pilot's seat of a People Express 737 at the company's austere Newark headquarters, sets a cost-cutting course.

Photographs by John Chso

What a Tight Fist Can Do



"You don't keep costs down by counting pencils and paper clips," says Larry Martin, a People Express general manager. "You have to squeeze massive productivity out of people and planes." People squeezes with the best. The figures represent the average costs per seat, per mile flown in 1981 by a sampling of airlines; annual figures are not yet available for many lines. The list includes three regional companies (USAir, Piedmont, and Frontier), three major trunks (TWA, Pan Am, and Eastern), and two new low-cost jet commuters (Muse and People).

gers. People Express flew 95 million revenue-passenger-miles in December, when New York Air flew 64 million passenger-miles and Midway 45 million.

People is the busiest airline at Newark Airport, with 72 departures and landings a day. Although the company lost $9 million on revenues of $38 million last year, it made a profit in December, its eighth month of flying—about $500,000 on revenues of $9 million by FORTUNE estimates. (In January, a slow month for air travel, People slipped back into the red.) Hambrecht & Quist, the venture-capital firm that underwrote People's public offering of three million shares in 1980, predicts the company could make as much as $10 million in 1982 if the air-travel market improves, as Hambrecht & Quist expects it to do later this year.

A wizard departs

People's prideful chirps of progress missed a few beats two weeks ago when President Gerald L. Gitner, 36, moved to Pan American as that troubled airline's senior vice president of marketing and planning. Gitner had held a similar position with Texas International before quitting to form People Express in April 1980 with two other Texas International employees, Burr and Melrose K. Dawsey, 33. A wizard of marketing and route selection, Gitner skipped about People's tiny headquarters like a kid in a wading pool, with an infectious spirit of fun and adventure.

Fortunately for People, Burr has a record that suggests he can fly solo. A Harvard Business School graduate, he left the presidency of a New York investment firm that invested solely in airlines to join Texas International in 1973, when it appeared to be going down the tubes. Seven years later, when he left to help found People, he was president and chief operating officer and Texas International had been turned around. Burr is the largest stockholder of People, with 715,000 shares. (Gitner has 330,000 shares. Dawsey, who is People's director of administration, has 41,000 shares, and five other officers have 50,000 shares each.) Burr views air travel with glib good humor as a commodity product like "steel, tennis balls, and dead chickens." He pooh-poohs such airline frills as hot meals and free magazines. "To be a winner," he claims, "you have to have the ultimate frill—nice people."

To keep spirits from sagging among People's people, Burr spent the day after Gitner announced his departure in company meetings explaining the move. Says Burr: "Our folks were saying, 'We thought you guys started something new and better. Why should we stay committed if the president is going to leave?' " Burr's answer: "Gerry loves planning and that's already done at People Express." Gitner concurs: "People went from zero to $82 million in assets in a year and a half. It's not a start-up anymore."

The ingredients of People's early success are hardly secret: rock-bottom fares and savvy marketing. People may have had the lowest costs of any airline in the country in 1981 (see chart, at left). In December People's cost per seat for each mile it flew fell to a phenomenal 5.4 cents, compared with, for example, 9 cents for Piedmont that month. General Manager Larry Martin, 33, says People's cost could fall below 5 cents when the airline adds three more planes to its fleet this month.

The company passes its economies on to passengers, who pay only 9.3 cents a mile for their tickets. According to Goldman Sachs, in the first nine months of 1981 two companies that compete with People on some routes were charging a system-wide average of 16.1 cents a mile (Piedmont) and 18.6 cents (USAir). People's stunningly low fares have forced other airlines to match its prices on competitive routes, even though their costs are higher. In April, for example, Piedmont was charging $82 for a ticket from Newark to Norfolk. When it heard People was going to fly the route, Piedmont slashed fares to meet those of the interloper—to $35 in peak hours and $23 at other times. The fare war is still raging.

The BSA special

To drive home its price message, People is putting on a mischievous ad campaign poking fun at other airlines and their patchwork quilt of fares. In one TV commercial, a reservation clerk at a fictitious competitor tells a customer: "You want the BSA Airlines super low-price special. OK? You simply fly one way, and pay the price you pay the other way if you fly two ways. OK? Simply put, each way costs half of either way, both ways, some days. OK?"

People probably couldn't survive solely by wresting market share from more established companies. In some cases, its competitors have customer recognition and the financial strength to withstand losses on selected routes indefinitely. When People started flying from Newark to Indianapolis it charged only $79 a ticket in peak hours, $59 off-peak. TWA and USAir, which were charging around $150 between New York and Indianapolis, matched People's prices. People couldn't drum up enough passengers and soon

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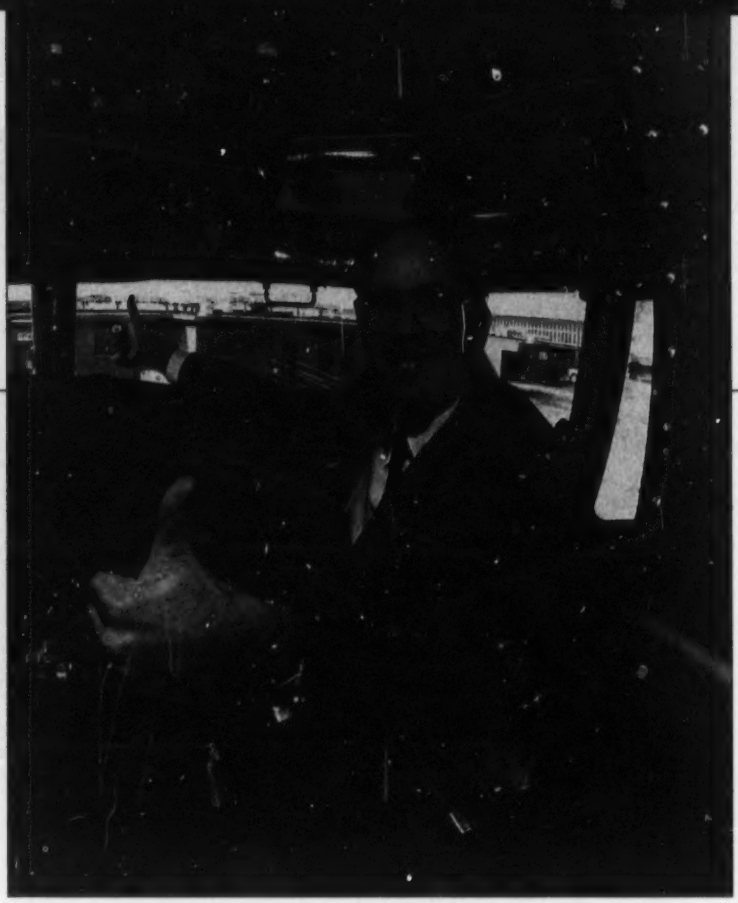
Research associate: Edward C. Baig

One Up, One Out



Melrose Dawsey (above) was an assistant to the chairman at Texas International when she helped found People Express. Now People's director of administration, she often fills in selling tickets in flight. Another founder, Gerald Gitner (right), has gone to Pan Am. He says People Express is in good hands: "After all, I trained them."

dropped the route. Says Burr, "We got blasted out of there." TWA and USAir have lifted their fares to $162.

Instead of taking passengers off competing planes, People hopes to lure them from the roads and rails on routes where there is a lot of ground traffic and not much airline service. In effect, People wants to preempt Greyhound's slogan, "Leave the driving to us." People Express ads read: "Flying that costs less than driving." A ticket from Newark to West Palm Beach, for example, costs $89 in peak hours and $69 off-peak. A bus or train ticket is more than $130. The trip by car—figuring 20 cents a mile and not counting food and lodging—costs about $250.

Enticing ground-lovers into the skies seems to work. After People started flying to Norfolk, a local newspaper reported that Greyhound sharply cut its service to the city and its environs, citing a decrease in ticket sales. Meanwhile, Norfolk airport traffic increased 18%.

Superman does it

Two kinds of travelers like People's fares: those with little money and those with plenty of money who would like to keep it. Senator Ted Kennedy was a passenger from Baltimore to Florida in December; his niece Caroline flew in February. Christopher Reeve, who played the title role in two *Superman* movies, took People from Newark to Boston. (You would think he could have flown still cheaper on his own.) On the planes, briefcases mix with backpacks, blue jeans and sailors' bell-bottoms with pinstripes. The cabins are clean, the seats close together, and the attendants refreshingly chipper. It's like a McDonald's of the air.

People has federal rule-making to thank for its price advantage. For years the Civil Aeronautics Board set fares based on average costs of the industry and prevented new competition from entering the business. Companies competed on service, not price. The high cost of providing the service (and of generous wage contracts) was easily passed along to travelers through regulated rates. After Congress changed the rules in 1978, it was a simple matter for newcomers organizing from scratch to move in with efficient operations.

No airline has done more than People Express to pare away extras. The first thing experienced travelers notice when flying People is that a lot of services they used to take for granted are either optional or have been eliminated. There are no hot meals; passengers must buy their snacks and beverages (beer and sandwiches cost $1; coffee is 50 cents). People Express takes reservations by telephone, but it has no ticket desks in the terminals. Nor is People hooked up to the industry's interconnected computerized ticketing systems. All tickets are sold on the plane. Unbundling these services alone knocks at least $18 off a ticket price.

Passengers are encouraged to carry their luggage on board; the planes are designed to take two small suitcases per passenger in the cabin. Bags can be checked before boarding—for a fee of $3 per bag. But checked luggage is not transferred to other airlines, making it necessary for passengers to pick up their own bags if they are connecting with other flights. The chief complaint about the luggage policy has come from the operators of the Columbus airport; all that bag-toting by People passengers was wearing out the carpet. The Columbus *Citizen-Journal* responded with a ringing editorial ("Get off People's back"), which advised the airport to "get some carpet that will last."

Lopping off the frills—some would call them necessities—is only the beginning of People's cost-cutting design. The company slashes far greater costs out of basic plant, equipment, and personnel. The founders selected Newark's nearly abandoned North Terminal because there was enough cheap space in the building for

continued

their entire headquarters, from reservation switchboards to corporate cubbyholes. Chairman Burr's spartan office, which doubles as a boardroom, rents for $6 per square foot a year; in the Pan Am Building in midtown Manhattan, space goes for about $50 a square foot. Rental fees for People's eight boarding gates are less than half those charged at Newark's ultramodern new terminal a half-mile away.

People Express works its sedate-looking tan, brown, and, maroon fleet hard. Its 737s were purchased from Lufthansa for $3.7 million each. (A new 737 costs as much as $17 million.) When Lufthansa flew the planes, each had 90 seats and a galley for hot meals. People took out the galleys and the first-class sections and added 28 seats per plane. A People 737 flies between ten and 11 hours a day, three or four more than the industry average. The additional seats and flying time more than double a plane's productivity without adding to capital costs. On the average, the planes fly 58% full—a good showing.

People gets as much out of people as it does out of planes. The company has about 800 full-time employees, or 57 per aircraft; the industry as a whole has about 149 people per plane. The secret of People's high labor productivity is not large amounts of overtime, but versatility. Because the company is not unionized, People's employees can be moved around to ease a crunch when one occurs. Each employee is trained—and is willing—to perform many tasks. Pilots fly about 70 hours a month (the industry average is around 45), but they also work as instructors, dispatchers, and schedulers.

Flight attendants are called "customer service managers"; they may spend one week a month looking after passengers aloft and the rest of the time taking reservations or keeping the books. Even executives like Melrose Dawsey regularly leave their desks to sell tickets and serve coffee. Burr, who occasionally pitches in to take reservations, claims this flexibility reduces the number of people on the payroll by at least 10%. Signs taped on corridor walls at headquarters announce: "Reservations needs help at peaks on Thursdays. Sign up, schedules permitting."

People Express urges travelers to carry their own luggage on board and charges if they don't.

In a lot of companies an open-ended call for volunteers would fall on deaf ears. But People employees have an incentive to respond—all, even the newest recruits, are stockholders. People may be the only publicly held company that requires every new employee to purchase 100 shares of stock, at a discount of about 60%. About a third of the company's 4.5 million shares are owned by employees. The stock, offered over the counter, has been hovering around $8.50 a share, exactly the price at which it was issued 16 months ago—not bad in this market.

Some get more

In this People's army, the officer staff totals 15 people. None is a vice president—a remarkable omission in the V.P.-prone airline industry. No one, not even Burr, has a secretary. Burr recalls that when he became president of Texas International in 1976, TI had a corporate staff of 350 and monthly revenues less than People's revenues today.

The company's brass doesn't pay itself excessively. Burr gets $48,000, as did Gitner before his departure. (He won't say what he will be paid at Pan Am.) People pilots earn $30,000 a year to start, compared with an average of $60,000 for members of the Air Line Pilots Association. Other People employees are paid *more* than the going rate for their positions. For example, customer-service managers start at $17,500 a year, well above entry-level pay for flight attendants at other lines. "This is a very democratic company," says Burr. "We've leveled the compensation scales and we intend to keep it that way. We want people motivated by feelings of ownership and peer pressure."

Being lean and entrepreneurial, People was able to move with remarkable speed at two crucial times in its short history. In January 1980, when the company set up shop in Newark, the headquarters-to-be was little more than a shell infested with rats. Only eight employees were on the payroll. Within four months the founders hired and trained 200 people, and People took to the air on schedule.

The second crucial time came after the air-traffic controllers' strike began in August. Access to most airports was restricted, and People had to abandon plans for flying some routes. The company couldn't afford idle planes, so a new strategy was hammered out during two emergency sessions over Gerry Gitner's dinner table in Morristown, New Jersey. The airline decided to start flying to Florida from smaller cities as well as Newark. Within weeks, People Express was originating Florida flights in Buffalo and Columbus. Business was good, and direct Florida flights largely accounted for the company's profitability in December. Burr says a major airline would have taken months to start flying the new routes.

When he was looking for financial backing a year ago, recalls Burr, investors laughed at his choice of Newark as the principal terminal, "and they thought charging passengers for food and drinks was even funnier. Everybody knows it's coffee, tea, or me—for free. Right?" These days it's Burr who is laughing. ■